Economic Outlook

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The continuing signs of economic strength since October have led many analysts to restore their higher pre-crash forecasts for economic growth in 1988. There is little evidence from surveys of consumers and businesses to suggest much impact from the stock market decline. While consumer confidence is lower, it still remains relatively high by historical standards and higher than it was last Christmas. This is not too surprising considering the November unemployment rate was down a full percentage point from the November 1986 level. There is not much evidence of a slowdown in recent business statistics either. Instead, measures of economic activity are suggesting the economy is still strong.

For example, payroll employment registered larger-than-expected gains in October and November. Initial claims for unemployment insurance remain at the lowest level in over 10 years. The Federal Reserve's "tan book" for the December FOMC meeting points to widespread strength in the economy as "most districts report overall economic expansion with particular strength noted in Boston, Chicago, Minneapolis, and San Francisco." According to the report, "The manufacturing sector has been a prime source of recent expansion in most districts." The continuing fast pace of manufacturing job growth also supports the Fed assessment, which is based on interviews and data gathered by each of the 12 Federal Reserve District banks. On a more troublesome note, the larger-than-expected October trade deficit was a setback for the transition to better balanced growth. Nevertheless, the sharp surge in imports is a definite sign of hefty demand in the U.S. economy.

Exports are growing as well, leading the nation's corporate purchasing managers to expect stronger economic growth in 1988. Their optimistic outlook is based on recent "significant increases in export business." The consensus in their mid-November semiannual survey expects this year's fourth quarter to be stronger than the third, and next year's first half to be stronger than the last half of 1987. The managers also see price increases picking up by about a half percent next year.

Some of the confusing crosscurrents in the economy are apparent in the motor vehicle markets. For example, November domestic car sales were off almost 7% compared with the same month in 1986. But year-end sales were relatively strong last year as buyers acted to take advantage of the sales tax deduction for the last time. Furthermore, when one adds in light truck sales, November sales were actually higher than last year. Over the past few years light trucks have comprised an increasing share of sales to consumers, as minivans and four-wheel drive vehicles have gained in popularity. These vehicles do not count as autos in the statistics. Strong employment is helping buoy vehicle sales, especially in manufacturing regions, where less of the population enjoyed the 1984-1986 consumer boom. Also supporting vehicle sales is the strong business sector, which buys a third of all automobiles and the majority of trucks. While consumer auto demand has moderated, businesses have been investing growing amounts in durable equipment, including autos and trucks.

Finally, the automobile import situation is interesting. While overall import sales were off about 3% in October and November compared with last year, luxury

imports were off by about 16%. This partly reflects the strength in luxury sales late last year, as high-income-tax bracket customers had stronger incentives to take advantage of the sales tax deduction before it ended. In addition, stiff price increases and the decline in stock prices probably account for some of the disproportionate hit to luxury imports. Unfortunately, the price increases could be large enough to offset the volume decline, leaving the nominal trade balance little improved, but unit import volume should slow as imported luxury car inventories build.

All in all, the motor vehicle sector illustrates the basic theme of the economic outlook: production continues to increase as consumption growth moderates and investment gains momentum. The main near-term risk is not recession, but excess inventory buildup if domestic and foreign demand is insufficient to absorb fast-rising output. An excess inventory buildup could eventually cause a recession. However, there is little evidence to date of widespread inventory excesses, and strong employment coupled with rising export demand should lead to a growing need to replenish inventories in many sectors rather than cutting them back. If demand persists at recent levels, producers will continue to invest to expand capacity, as more and more industries encounter production bottlenecks over the next year.

Robert T. McGee

Real GNP

(Percent Contribution to Real GNP Growth; Annual Rates)	Actual				Forecast				Actual	Forecast	
	1986	1987			1987			1988	1985-	1986-	1987-
	IV	I	II	III	IV	I	II	III	1986	1987	1988
Consumer Spending	0.3	-0.5	1.2	3.2	0.0	0.8	0.8	1.0	2.7	1.3	1.0
Business Investment	0.6	-1.9	1.3	2.8	1.5	0.6	0.6	0.6	-0.3	0.2	1.1
Residential Investment	0.1	-0.4	-0.2	-0.3	0.0	-0.1	-0.1	-0.1	0.6	0.0	-0.1
Change in Inventories*	-0.1	4.4	-1.6	-1.6	0.7	0.8	0.5	0.2	0.0	0.2	0.1
Net Exports	1.1	1.8	0.3	-0.2	1.0	0.8	0.9	0.7	-1.0	0.4	0.7
Government Purchases*	-0.5	1.0	1.5	0.2	0.5	0.5	0.5	0.5	0.9	0.7	0.5
Real GNP	1.5	4.4	2.5	4.1	3.7	3.4	3.2	2.9	2.9	2.8	3.3

Quarterly Economic Indicators

(Percent Changes at Annual Rates)	Actual				Forecast				Actual	Forecast	
	1986	1987			1987			1988	1985-	1986-	1987-
	IV	I	II	III	IV	I	II	III	1986	1987	1988
Nominal GNP	2.1	8.6	6.3	7.0	7.7	7.8	8.1	8.4	5.6	5.9	7.8
GNP Deflator	0.7	4.2	3.5	2.8	4.0	4.4	4.9	5.3	2.6	3.0	4.3
Corporate Profits After Tax#	-0.3	6.7	9.9	6.3	6.3	12.5	10.1	8.5	-1.0	7.3	9.5

Monthly Economic Indicators

	Recent Data			Actual	Forecast	
	Sept.	Oct.	Nov.	1986	1987	1988
Consumer Price Index** (%)	0.2	0.4	n.a.	1.1	4.8	6.0
Industrial Production (%)	-0.3	0.9	0.4	1.0	3.6	4.3
Retail Sales (%)	-1.7	-0.9	0.2	5.5	3.8	4.1
Auto Sales (million units, a.r.)	11.8	9.2	9.8	11.5	10.3	10.0
Housing Starts (million units, a.r.)	1.65	1.51	n.a.	1.81	1.66	1.53
Unemployment Rate (%)	5.9	6.0	5.9	7.0	6.2	5.5
Merchandise Trade Deficit ($ bn., a.r.)	-169.0	-211.6	n.a.	-156.2	-168.0	-135.0

*Adjusted for CCC purchases. **Annual percent changes are December to December. December 15, 1987
#Quarterly data are year-over-year percent changes.
a.r.=annual rate F=Forecast